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Colt Industries Operating Corp. (1985) (F) (Corp)

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RE: Colt Industries Operating Corp. Docket No. 84-63-2A-A Corporate Income Tax Assessment - Tax Years 1978 & 1979 Docket No. 84-41-2A-A Corporate Income Tax Assessment - Tax Years 1981 & 1982

Herbert L. Herman

Assistant Treasurer

Director of Taxes

Colt Industries, Inc.

430 Park Avenue

New York, NY 10022

Dear Mr. Herman:

The Tax Review Committee has met once again and hereby issues its findings with respect to the above entitled protests.

FACTS

The Protestor, Colt Industries Operating Corporation, is a Delaware corporation engaged in the manufacture and sale of industrial and commercial items including large engines, machine tools, compressors, pumps, firearms, carburetors, industrial seals, and weighing equipment amongst others. Protestor has principle manufacturing plants located in Connecticut, Illinois, Kansas, Kentucky, Michigan, Mississippi, North Carolina, Oklahoma, Tennessee, Vermont and Wisconsin. Its commercial domicile and corporate headquarters are located in New York, New York. The Protestor has a service office in Iowa which is part of its Weighing Division and maintained to service scales sold by it.

Protestor is a wholly owned subsidiary of Colt Industries, Inc., which does business in all fifty states and internationally. For fiscal tax years 1978 through 1982 and ending with the last day in October, the Protestor filed consolidated federal income tax returns with its parent company. On October 31, 1979 and on October 30, 1980 Protestor timely filed Iowa corporation income tax returns for the respective 1978 and 1979 calendar years.

In 1982 Protestor's federal income tax returns were audited. As a result, adjustments were made to the federal returns and later to the Iowa returns.

These protests concern two certified notices of assessment. First, a certified notice of tax assessment was issued on December 16, 1983 to the Protestor for corporate income tax for calendar years 1978 and 1979 and totalling \$15,213 including tax, fee and accrued interest.

The Protestor contests whether the aforesaid assessment was issued within the statute of limitations. This matter has been addressed by the Tax Review Committee in its preliminary findings of fact letter of June 16, 1984. That letter, which found the assessment for tax years 1978 and 1979 was timely, is now incorporated within these findings in its entirety by this reference. See Exhibit A attached.

Also on December 16, 1983 the Department issued to the Protestor a certified corporation income tax assessment for calendar years 1981 and 1982 and totalling \$33,056 including tax, fee, penalty and accrued interest. A penalty was assessed on the 1981 tax period. On February 14, 1984 the Protestor timely appealed the corporation income tax assessment for the 1981 and 1982 calendar years in Docket No. 84-41-2A-A. On March 1, 1984 the Protestor timely appealed the corporation income tax assessment relating to fiscal years 1978 and 1979 in Docket No. 84-63-2A-A.

In Docket No. 84-63-2A-A Protestor asserts the following errors with respect to the 1979 corporation income tax year:

1. Capital gain of \$903,802 on sale of foreign (Mexican) corporation's stock should have been allocated as the foreign corporation had no contact with Iowa; and 2. Dividend income of \$61,952 (including \$7,554 of foreign dividend gross-up) from a foreign subsidiary should be allocated as the foreign subsidiary had no contact with Iowa. Additionally, the gross-up is not taxable in Iowa.

In Docket No. 84-41-2A, Protestor asserts the following errors with respect to the 1981 and 1982 corporation income tax year:

1. Interest income from commercial paper of \$48,455, certificates of deposit of \$104,180 and foreign nonsubsidiary source income of \$1,432 should be allocated as there is no connection between this income and Petitioner's activities within Iowa.
2. Dividend income of \$320,600 (including \$128,539 of foreign dividend gross-up) and \$95,772 foreign subsidiary dividend income should be allocated as such dividends had no connection with Iowa.
3. Royalty income received from licensing rights to manufacture, use and sale the M-16 rifle by Petitioner's Firearms Division should be allocated.
4. Capital gain of \$23,878,772 received in 1981 from the sale of Petitioner's leasehold interest in a building located in New York City should be allocated as it was isolated, unrelated income to Iowa.
5. Petitioner's failure to pay 90% of the 1981 tax liability was due to reasonable cause and not willful neglect nor disregard of Iowa law. Its failure to pay was due to its interpretation of case law and its applicability to Iowa.

In sum, Petitioner claims that the above capital gain, dividend income, interest income and royalty income is not taxable by Iowa and the penalty should be waived for the assessed corporation income tax years. The answer to these claims lies in whether or not the income from Protestor's operations were business income, subject to apportionment, or nonbusiness income, allocable outside of Iowa.

FINDINGS AND REASONING

As stated earlier, the findings by this Committee issued on June 6, 1984 relating to the statute of limitations in Docket No. 84-63-2A-A are incorporated herein and by reference are made a part of these findings. (See Exhibit A.)

The Committee finds that the interest income from commercial paper and certificates of deposit should be apportioned as business income for the years in question. Protestor has provided no evidence substantiating allocation of this interest income.

With respect to the noncontrolled subsidiary's income, the Committee finds that the income should be allocated as non-business income for the years in question. Colt Industries does not have a controlling interest in Manufacturers Fairbanks Morris SA, Fairbanks Morris of India (PVT) Limited, and Dynamics Corporation of America. Furthermore, the Committee finds that the foreign dividend gross-up should be allocated.

The Committee finds that the royalty income should be apportioned as business income. Here, the assets producing the royalties were developed by Protestor as a regular part of its trade and business which consists

of manufacturing and selling M-16 rifles. Hence, the royalty income is incidental to the Firearms Division's manufacture and sale of weapons.

The Committee finds that the capital gains from the sale of the leasehold interest in 1982 is apportionable as business income. This capital gain represents the most significant portion of the tax assessed in Docket No. 84- 41-2A-A.

The Committee further finds that the Protestor's operation is unitary. The Protestor's total operating income is derived from a unitary business which Protestor apportions within and without Iowa on its Iowa income tax returns. Merely because Protestor may do business by relatively autonomous and diverse divisions under the same corporate umbrella does not make such divisions nonunitary. *Comptroller v. Ramsey, Scarlett & Co.*, 473 A.2d 469 (Md. App. 1984); *Russell Stover Candies v. Department of Revenue*, 665 P.2d 198 (Mont. 1983);

Exxon Corp v. Wisconsin, 447 U.S. 207, 65 L.Ed.2d 66, 100 S.Ct. 2109 (1980).

The leasehold interest of the Protestor existed in the office building where Protestor was and is located. Protestor's parent acquired the leasehold interest in 1969. The parent used four out of eighteen floors in the building and subleased the other fourteen floors to outside third parties.

In February 1981, the parent assigned the leasehold interest to Protestor "in order to enhance not only its equity investment in its wholly owned subsidiary, but also to facilitate the then anticipated working capital requirements of its subsidiary which would result from the proceeds of the pending sale of the leasehold." Protestor's letter of January 10, 1985.

In short, the purpose of the assignment and the March 1981 sale of the leasehold interest was to generate working capital to subsidize Protestor's unitary business operations, a portion of which were conducted in the state of Iowa. But for the capital gain from the leasehold interest, Protestor, to secure such capital, would have had to borrow the funds with resulting expense to Protestor's unitary business. Had Protestor borrowed working capital, it would have been allowed to deduct, on its Iowa return, interest expense from apportionable operating income.

The use of the assignment and sale of the leasehold interest is a substitute method of raising working capital instead of borrowing it. Therefore, the capital gain from the sale of the leasehold interest should have the same unitary status as interest expense paid to borrow working capital. Thus, using this rationale, the Committee finds that the capital gain from the sale of the leasehold is business income.

In *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 73 L.Ed.2d 787, 102 S.Ct. 3103 (1982), certain investment income was held to be nonunitary with the taxpayer's operating income. Significantly, the Supreme Court noted that the taxpayer had a sufficient cash flow from operating income so that it did not have to rely upon the cash flow from investment income to operate its principal trade or business. By Protestor's own admission, that is not true in the instant situation in that the sale of the leasehold interest in the building did facilitate Protestor's working capital requirements for its unitary business.

In *Lone Star Steel v. Dolan*, 668 P.2d 916 (Colo. 1983), the Colorado Court held that investment by the taxpayer of surplus funds to accumulate interest to be used as working capital to partially finance the taxpayer's principal trade or business was a part of the taxpayer's unitary business so that the interest income derived from such investment constituted business income. The taxpayer was in the steel business and the interest income investment was held to be sufficiently connected to the steel business.

In *District of Columbia v. Pierce Associates*, 462 A.2d 1129 (D.C. App. 1983), the taxpayer, a manufacturer, received insurance proceeds from damage to its Virginia plant. Since the insurance proceeds were sufficiently connected to the taxpayer's unitary business, a portion of which was carried out in the District of Columbia, the extraordinary nature or infrequency of the activity resulting in the insurance proceeds income was deemed irrelevant.

The principles in *Lone Star Steel* and *Pierce Associates*, which applied to the *ASARCO* case principles, are applicable to the Protestor's leasehold interest. The sale of the leasehold interest is sufficiently connected to

Protestor's unitary trade or business so as to justify business income treatment. The fact that the leasehold interest was in the building in New York, rather than in Iowa, and that the sale of the leasehold interest was an isolated occurrence are irrelevant.

Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223 (1980); Lone Star Steel, supra; Pierce Associates, supra.

The Protestor's brief investment in the leasehold interest resulted in a capital gain which facilitated and was needed by Protestor to subsidize, in part, its unitary business, a portion of which was conducted in Iowa. It is not possible to quantify this benefit for Protestor. Therefore, formulary apportionment is appropriate. There is no showing that this inclusion of the capital gain in Protestor's preapportionment net income base and application of the Iowa business activity ratio (formula) results in Iowa taxation out of all appropriate proportion to Protestor's Iowa business activities. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 57 L.Ed.2d 197, 98 S.Ct. 2340 (1978); Container Corporation of America v. Franchise Tax Board, U.S. , 77 L.Ed.2d 545 (1983).

It is also relevant that Protestor treated the rental income from leasing the office building as business income on Protestor's 1981 Iowa income tax return. If the leasehold produced business rental income, the capital gain from its sales should likewise produce business income. See, ASARCO, supra.

For the aforementioned reasons, the Committee finds that it is within the realm of "permissible judgement" (Container, 77 L.Ed.2d at 560) to require the Protestor to include capital gain from the sale of the leasehold interest in its preapportionment net income base. The Committee finds that the application of the Iowa business activity ratio is not unreasonable as applied.

Lastly, the Protestor contends that the penalty assessed for the 1981 tax year should be waived due to its belief that no taxes were due to the state of Iowa as provided by law. Protestor does not dispute that it failed to pay 90% or less of the tax as computed by the Department. The Protestor has burden to show that failure to timely pay the tax due was due to reasonable cause. See *Armstrong's, Inc. v. Iowa Department of Revenue*, 320 N.W.2d 623 (Iowa 1982). Section [422.39](#), Iowa Code, imposes a penalty for failure to pay "unless it is shown that such failure was due to reasonable cause and not due to willful neglect."

The Department has consistently held that uninformed or unsupported belief is insufficient to constitute reasonable cause. *Henningsen v. Commission of Internal Revenue*, 243 F.2d 954, 959 (4th Cir. 1957), stated that "there is no uncertainty as to the settled rule that uninformed and unsupported belief or an innocent mistake does not of itself constitute reasonable cause."

This contention is further supported in *Olga de Belaieff v. Commissioner*, 15 TCM 1426, 1430 (1956), which cited *Fraternal Order of Civitans of America*, 19 T.C. 240 [Dec. 19, 1954], "wherein it was held that sincere belief on the part of the taxpayer that it was exempt did not constitute reasonable cause under the statute." The fact that the Protestor was mistaken about the Iowa law does not constitute reasonable cause. Therefore, the Committee finds that there has been no showing that penalty should be waived in this case.

In sum, the Committee finds Protestor is a unitary operation doing business in and out of Iowa; the assessment for tax years 1978 and 1979 was timely; the 1979 capital gain from the sale of Mexican subsidiary stock and foreign dividend gross-up should be allocated; income from noncontrolled subsidiaries for 1980 and 1981 should be allocated; income from royalties, controlled subsidiaries, sale of the leasehold and interest from commercial paper and certificates of deposit should be apportionable; and the penalty should not be waived.

Additionally, the Committee finds that no showing was made that the application of the Iowa formula results in Iowa taxation of Protestor's unitary business out of all appropriate proportion to Protestor's Iowa business activities.

Please advise me of your position in light of the enclosed Findings within thirty days of the date of this letter. If you agree, or choose not to pursue the Protest, please inform me in writing. Your letter and receipt of the amount due which is \$51,084.90 through August 31, 1985 directed to my attention, will serve as authority for the hearing officer to close the Protests. Additional interest accrues for each month after August.

If the Protestor is in disagreement with the Findings and chooses to pursue the Protest, the Department will file an Answer to the Protest pursuant to rule 730-7.12(17A), IAC, thereby initiating contested case proceedings. The hearing officer of the Department will then notify all parties of a time and place for an evidentiary hearing to be held on this matter. If no response is received within thirty (30) days of the date of this letter, the Committee will construe this inaction as failure to pursue the Protest and will request dismissal of the Protest pursuant to department rule 730-7.11(2).

If you have any questions with regard to this matter, please do not hesitate to contact me.

Very truly yours, Elizabeth G. Beck Attorney at Law Appeals Section 515/281-4071